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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1994

CITIZENS BANK OF MARYLAND,

Petitioner,

v.

DAVID STRUMPF,

Respondent.

ON WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

BRIEF FOR THE PETITIONER

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QUESTION PRESENTED

Whether a bank creditor may refuse a bankrupt depositor's request to withdraw funds pending determination by the bankruptcy court of the bank's setoff right, without violating the bankruptcy stay under 11 U.S.C. §362(a).

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OPINIONS BELOW

The opinion of the United States Court of Appeals for the Fourth Circuit is reported at 37 F.3d 155 (4th Cir. 1994). (J.A. 39a). The opinion of the United States District Court for the District of Maryland is reported at 138 B.R. 792 (D. Md. 1992). (J.A. 31a). The ruling of the United States Bankruptcy Court for the District of Maryland is not reported. (J.A. 27a, 29a).

JURISDICTION

The United States Court of Appeals for the Fourth Circuit entered its judgment on October 13, 1994. The court of appeals entered an order denying Citizens Bank of Maryland's motion for rehearing, or in the alternative, suggestion of rehearing in banc on November 8, 1994. Citizens Bank of Maryland's petition for a writ of certiorari was filed in this Court on February 6, 1995, and was granted on March 27, 1995. This Court has jurisdiction under 28 U.S.C. §1254(1).

STATUTORY PROVISIONS INVOLVED

This case involves consideration of five sections of the United States Bankruptcy Code, 11 U.S.C. §§101, *et seq.* (1988).[1] They are 11 U.S.C. §§362, 363, 506(a), 542(b) and 553. The pertinent text of each of these sections is set forth in the Appendix found at the end of this Brief. Because this case was commenced prior to the Bankruptcy Reform Act of 1994, enacted on October 22, 1994, the provisions of the Code referred to in this Brief are those in effect prior to the 1994 amendments. None of these provisions, however, has been amended by the Bankruptcy Reform Act of 1994 in a manner material to the outcome of this case.

This case also raises a question under the Fifth Amendment to the United States Constitution, which provides: "No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any

[1]The United States Bankruptcy Code is hereinafter sometimes referred to as the "Bankruptcy Code" or the "Code."

person be subject for the same offence to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation." U.S. Const. amend. V.

STATEMENT OF THE CASE

On November 28, 1989, the Petitioner, Citizens Bank of Maryland ("Citizens"),[2] loaned the Respondent, David Strumpf ("Strumpf" or the "Debtor"), $5,068.75. The loan was evidenced by an unsecured consumer loan note ("the Note"), (R. 1) (the Note),[3] in which Strumpf agreed to repay the loan (including interest) in twenty-four monthly installments. The Note provided for the immediate acceleration of the amount due upon default, the payment of attorney's fees, and expressly granted Citizens the right of setoff upon default. *Id.*

On January 25, 1991, Strumpf filed a petition for relief under Chapter 13 of the Bankruptcy Code in the United States Bankruptcy Court for the District of Maryland. (J.A. 3a); (R. 1) (Chapter 13 plan, statement,

[2]Pursuant to Supreme Court Rule 29.1, Citizens discloses that Citizens Bank of Maryland is a wholly owned subsidiary of Citizens Bancorp, a bank holding company chartered under the laws of the state of Maryland, the stock of which is publicly traded. Citizens Bank of Maryland has no subsidiaries, other than wholly owned subsidiaries.

[3]As the pages of the certified record are not consecutively paginated, citations to the record are to the docket entry in the record, followed by a parenthetical describing the specific document within the docket entry to which citation is made. For example, in this citation, the Note may be found at docket entry number 1 (which is the entire bankruptcy court record as submitted to the district court) of the certified record.

and statement of affairs with voluntary petition). At the time of the filing of his bankruptcy petition, Strumpf had a checking account with Citizens containing a balance of $11,279.86, and the Note was in default. (J.A. 18a-19a).

On or about February 26, 1991, the bankruptcy court issued to Strumpf's creditors a copy of an Order for Meeting of Creditors, Combined with Notice Thereof and of Automatic Stays, informing them of Strumpf's bankruptcy filing and other important dates for the case. Included among these dates was June 13, 1991, the date by which creditors had to file a proof of claim in order to have a claim allowed and to share in distributions from the estate. (J.A. 5a). In accordance with that order, Citizens timely filed its proof of claim on June 13, 1991, asserting a secured claim in the amount of $2,555.50. On April 8, 1991, the bankruptcy court entered an order confirming Strumpf's Chapter 13 plan. (J.A. 10a). The plan made no mention of Citizens or its particular claim.

On October 7, 1991, Citizens filed in the bankruptcy court a Motion for Relief from Automatic Stay and for Setoff, asking the bankruptcy court for permission to exercise its right to set off Strumpf's debt to Citizens under the Note against funds held on deposit in Strumpf's checking account at Citizens. (J.A. 15a). As stated in Citizens' motion, the amount then due on the Note, including attorney's fees, was $3,259.68. Contemporaneously with the filing of the motion, Citizens placed an administrative "hold" on $3,500.00 in Strumpf's checking account, the balance of which was then $7,206.59. (J.A. 26a). The administrative hold allowed Strumpf to withdraw from his account all but $3,500.00, thus preventing Strumpf from withdrawing funds to which Citizens claimed a setoff right.

On October 9, 1991, Strumpf filed a motion to hold Citizens in contempt, claiming that the administrative hold on his bank account violated the automatic stay of 11 U.S.C. §362(a). (J.A. 23a). The Debtor also filed on October 31, 1991, a second motion against Citizens, requesting that Citizens be ordered to release the administrative hold and turn over all funds in the account to Strumpf. (R. 1) (Strumpf's motion seeking release of administrative hold and turnover of funds). On November 4, 1991, the bankruptcy court (the Honorable Paul Mannes, Chief Judge, presiding), held a hearing on Citizens' motion for relief from automatic stay and for setoff, at the conclusion of which the court requested Strumpf's counsel to submit a legal memorandum and reserved ruling on the merits. (R. 1) (transcript of Nov. 4, 1991 hearing). On November 13, 1991, Judge Mannes held a hearing on Strumpf's motion to hold Citizens in contempt, and granted the motion, holding Citizens in contempt for violating the automatic stay and awarding Strumpf attorney's fees of $500.00, punitive damages of $375.00, and nominal damages of $25.00. (J.A. 27a).

In reaching this result, the court clearly felt bound by the decision of the Fourth Circuit in *United States v. Reynolds,*[4] stating that under *Reynolds*, "I have to find that Citizens Bank violated the stay of 11 U.S.C. §362(a)(7) through the administrative freeze process used here." (R. 1) (transcript of Nov. 13, 1991 hearing). Judge Mannes indicated that his own view of the correct result may have been different: "Were the decision on my part one written on a clean slate, I might look at the case somewhat differently." *Id.*

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[4] 764 F.2d 1001 (4th Cir. 1985). *See infra* at 36-38 for a discussion of the *Reynolds* case.

On December 2, 1991, the bankruptcy court granted Citizens' motion for relief from the automatic stay, authorizing Citizens to exercise its right of setoff against the funds in Strumpf's account. (J.A. 29a). By that time, however, Citizens was unable to effectuate a setoff because Strumpf had withdrawn all of the funds from his account after Citizens lifted the administrative hold as required by the bankruptcy court's earlier contempt order.

Citizens appealed the bankruptcy court's decision on Strumpf's contempt motion to the United States District Court for the District of Maryland (the Honorable John R. Hargrove, presiding). (R. 1) (notice of appeal). Strumpf did not appeal from the bankruptcy court's order granting Citizens relief from the automatic stay. The district court reversed the decision of the bankruptcy court, summing up the proceedings below:

> The ironic result for Citizens Bank was that it was held in contempt, was later granted its Motion for Relief From Automatic Stay and for Setoff, but could not exercise its right to setoff because (as predicted by Citizens Bank) Strumpf had removed the money from the checking account. This series of events rendered the Bankruptcy Court's ultimate granting of Citizens Bank's Motion meaningless.

(J.A. 31a, 37a); *Citizens Bank of Maryland v. Strumpf*, 138 B.R. 792, 794 (D. Md. 1992), *rev'd*, 37 F.3d 155 (4th Cir. 1994). The district court held that the placement of an administrative hold on funds in an account pending the bankruptcy court's ruling on a motion for relief from stay did not equate to a setoff and did not violate the automatic stay. *Id.* As stated by the district court, "permitting the bank to freeze the funds until such time as the Court rules on the Bank's Motion for

Relief from Automatic Stay and for Setoff is the only sensible procedural approach under these circumstances." *Id.*

Strumpf appealed the district court's judgment to the United States Court of Appeals for the Fourth Circuit, which reversed the district court's ruling and remanded the case for reinstatement of the bankruptcy court's order. (J.A. 39a); *Citizens Bank of Maryland v. Strumpf*, 37 F.3d 155, 159 (4th Cir. 1994). The opinion of the Fourth Circuit followed the earlier decision of a panel of the same court in *United States v. Reynolds*, 764 F.2d 1004 (4th Cir. 1985), a case involving a "freeze" of a tax refund by the Internal Revenue Service, and concluded that the administrative hold was "tantamount" to a setoff and violated 11 U.S.C. §362(a)(7). *Strumpf*, 37 F.3d at 158. The court further reasoned that while the "banker's dilemma" created by mutual obligations between a bank and its depositor may allow a debtor to defeat a creditor's right of setoff, the language of §362(a) produces this result. *Id.* at 149. On October 27, 1994, Citizens filed a petition for rehearing or, in the alternative, suggestion of rehearing in banc with the Fourth Circuit. On November 8, 1994, this petition was denied.

On February 6, 1995, Citizens filed a petition for a writ of certiorari with this Court, seeking reversal of the Fourth Circuit's decision, and citing to conflict among the lower courts regarding the propriety of the use of an administrative hold in bankruptcy as a substantive basis for this Court's review of the case. On March 27, 1995, this Court granted Citizens' petition for a writ of certiorari.

SUMMARY OF THE ARGUMENT

The right to setoff mutual debts has long been recognized in American common law, and in bankruptcy law. The doctrine of setoff is premised upon the "absurdity of making A pay B when B owes A," *Studley v. Boylston Nat'l Bank*, 229 U.S. 523, 528 (1913), and recognizes the inherent fairness and efficiency in canceling mutual obligations to arrive at one true debt.

The application of this setoff doctrine in cases under the Bankruptcy Code involving a nonbank creditor is straightforward and has generated little controversy, with the exception of cases involving the Internal Revenue Service ("IRS"). The Bankruptcy Code, in §553, expressly recognizes and preserves a creditor's right of setoff. The automatic stay under §362(a)(7) prevents the creditor from exercising its setoff right without first obtaining the bankruptcy court's permission. However, under §542(b) of the Bankruptcy Code, the creditor is not required to pay its debt to the debtor, to the extent of the creditor's claim against the debtor. The mere refusal by the creditor to pay its debt to the debtor is not considered to constitute a setoff and, therefore, is not considered to be a violation of the automatic stay.

The confusion surrounding setoffs under the Bankruptcy Code primarily has arisen if the creditor is a bank where the debtor maintains a bank account and the bank takes some action after the commencement of the depositor's bankruptcy case to restrict the debtor's ability to use the funds on deposit. A bank creditor generally has a right under nonbankruptcy law to offset a depositor's bank account, that is, deduct from the account and apply the amount of deduction to reduce the balance due on the depositor's defaulted debt to the bank. Upon commencement of a bankruptcy case, the bank will

want to preserve its ability to exercise its setoff right against the debtor's bank account, after being authorized to do so by the bankruptcy court, by ensuring that the account funds are not dissipated. The confusion in these cases arises in part from the lower courts' misapprehension of the nature of the relationship between a bank and its depositor.

This Court has long recognized that a bank account creates the relation of debtor and creditor between the bank and its depositor. The money deposited in legal contemplation is a loan to the bank and becomes part of the general funds of the bank, and the depositor has the right to draw on the account to the extent of the deposit. When the depositor files a bankruptcy petition, §542(b) entitles the bank to refuse to pay its obligation to the debtor from the bank's assets to the extent the bank has a right of setoff. The method used by a bank to refuse to pay its obligation to a debtor with respect to the debtor's bank account is referred to as an administrative "hold" or "freeze."

The issue presented in this case is whether the bank can place an administrative hold on the debtor's bank account to preserve the bank's right of setoff against the account prior to obtaining relief from the automatic stay to exercise its setoff right. During the course of Strumpf's bankruptcy case below, Citizens placed an administrative hold on a portion of Strumpf's account at Citizens and contemporaneously filed a motion requesting the bankruptcy court to modify the automatic stay to permit Citizens to accomplish a setoff.

Consistent with §542(b), the imposition of an administrative hold on Strumpf's bank account was not itself a setoff. To the contrary, by filing a motion requesting the bankruptcy court's authority to exercise its setoff

right contemporaneously with its imposition of the administrative hold, Citizens made clear its intention to delay the actual exercise of its setoff right pending bankruptcy court approval. This limited hold on the account did not accomplish the setoff; the balance of the account was not reduced by the amount of the setoff and Citizens in all respects acted in a manner evidencing that the setoff had not been accomplished.

The Fourth Circuit panel below focused only on §§362(a)(7) and 553 of the Bankruptcy Code, and ignored the impact of §§363, 506(a) and 542(b). That error, coupled with the Fourth Circuit's apparent failure to recognize the nature of a bank account as the bank's debt to the debtor rather than funds owned by the debtor, predictably led the Fourth Circuit to the wrong conclusion.

If a financial institution, or for that matter nonbank creditors, were to be denied the ability to use a temporary hold to preserve the *status quo* pending determination of the parties' respective rights, the creditor's valid setoff right would be nullified by the debtor's ability to withdraw or collect the funds faster than the bankruptcy court could rule on the matter. A ruling by the bankruptcy court recognizing the bank's setoff right after all funds are withdrawn is the proverbial attempt to lock the barn door after the horse has been stolen. That is precisely what happened in this case. By the time the bankruptcy court granted Citizens relief from the automatic stay to exercise its right of setoff, Strumpf had withdrawn all of the funds on deposit at Citizens, leaving Citizens with a hollow right and no remedy.

Consequently, the absurdity long eschewed by the doctrine of setoff became a reality in this case. The Bankruptcy Code neither requires nor supports a nullification of a creditor's right of setoff. Accordingly, Citizens respectfully asks this Court to reverse the decision below and to reinstate the decision of the district court.

ARGUMENT

I.

THE BANKRUPTCY CODE EXPRESSLY RECOGNIZES AND PRESERVES A CREDITOR'S SETOFF RIGHT AGAINST A DEBTOR.

A. Citizens Had a Contractual and Common Law Right to Set Off the Debtor's Bank Deposit Against His Obligation to the Bank Prior to the Commencement of the Bankruptcy Case.

The right to set off mutual debts has long been recognized as a venerable right in American common law. Premised upon the "absurdity of making A pay B when B owes A," *Studley v. Boylston Nat'l Bank*, 229 U.S. 523, 528 (1913), the doctrine of setoff recognizes the inherent fairness and efficiency in canceling mutual obligations to arrive at one true debt. The Fourth Circuit's ruling below effectively eviscerates the ability of financial institutions to exercise this important right within the context of a bankruptcy case.

In Maryland,[5] the right of setoff has been defined as,

> the right which exists between two parties, each of whom, under an independent contract, owes an

[5] Because both the Debtor and Citizens, as well as the bank account at issue, are in Maryland, Maryland law determines the state law rights and obligations of the parties. In the absence of controlling federal law, Citizens' interest in Strumpf's bank account by virtue of its setoff right is a creature of state law. *See Butner v. United States*, 440 U.S. 48, 54 (1979) ("Congress has

[footnote continued]

> ascertained amount to the other, to set off their respective debts by way of mutual deduction, so that in any action brought for the larger debt, the residue only after such deduction, shall be recovered.

Ghingher v. Fanseen, 166 Md. 519, 526, 172 A. 75, 78 (1934) (quoting 24 R.C.L. 792). The right of setoff has been recognized in Maryland continuously since 1785. *See generally* William H. Loyd, *The Development of Setoff*, 64 U. Pa. L. Rev. 541 (1916) (exhaustive analysis of the ancient roots of the doctrine of setoff). *See, e.g., Baltimore Ins. Co. v. M'Fadon*, 4 H. & J. 31, 41-45 (Md. 1815) (interpreting right of setoff established in Maryland by Act of 1785, ch. 45, s. 7); *Tyrrell v. Tyrrell*, 54 Md. 167, 169 (1880); *District Agency Co. v. Suburban Delivery Serv., Inc.*, 224 Md. 364, 370, 167 A.2d 874, 877 (1961) (holding Maryland rules of civil procedure regarding counterclaims encompass right of setoff).

Under Maryland law, a bank creditor may offset money in its customer's bank account against a mature obligation of the customer owed to the bank. *See Hayden v. Citizens Nat'l Bank of Baltimore*, 120 Md. 163, 167, 87 A. 672 (1913); *Records v. McKim*, 115 Md. 299, 305, 80 A. 968 (1911); *Mercantile-Safe Deposit and Trust Co. v. Delp and Chapel Concrete Constr. Co.*, 44 Md. App. 34, 44, 408 A.2d 1043, 1049 (1979); *In re Cummins Constr. Corp.*, 72 F. Supp. 409, 413-14 (D. Md.), *aff'd*, 164 F.2d 983 (4th Cir. 1947), *cert. denied*, 333 U.S. 881 (1948). The foundation for a bank's right of setoff is the creditor-debtor relationship between a depositor and his bank that is created when the depositor opens a bank account.

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generally left the determination of property rights in the assets of a bankrupt's estate to state law."); *McKenzie v. Irving Trust Co.*, 323 U.S. 365, 370 (1945).

The money an account holder deposits into his bank account is, in legal contemplation, a loan to the bank, payable upon demand:

> It may be said generally that the relation of a bank and a depositor is that of debtor and creditor; the money deposited is regarded as a loan to the bank by the depositor, with the right of the depositor to draw on it to the extent of the deposit.

Keller v. Fredericktown Sav. Inst., 193 Md. 292, 296, 66 A.2d 924, 925 (1949). *See also Taylor v. Equitable Trust Co.*, 269 Md. 149, 155, 304 A.2d 838, 842 (1973); *Gordon, Feinblatt, Rothman, Hoffberger & Hollander v. Gerhold*, 90 Md. App. 360, 376, 608 A.2d 1194, 1201 (1992).

From a nonlegal perspective, it is common, but incorrect, for a depositor to think that the funds in his bank account remain the depositor's funds, just as if they were placed in a safe deposit box and held by the bank for safekeeping. The law is to the contrary. Upon deposit of monies into an account, the bank becomes the owner of the funds. The depositor loses the right of immediate possession of the funds but gains a claim against the bank for an amount equal to the balance in the account. As this Court stated in *New York County Nat'l Bank v. Massey*, 192 U.S. 138, 145 (1904),

> [i]t cannot be doubted that, except under special circumstances, or where there is a statute to the contrary, a deposit of money upon general account with a bank creates the relation of debtor and creditor. The money deposited becomes a part of the general fund of the bank, to be dealt with by it as other moneys, to be lent to customers, and parted with at the will of the bank, and the right of the depositor is to have this debt repaid in whole or in part by

> honoring checks drawn against the deposits. It creates an ordinary debt, not a privilege or right of a fiduciary character.

Accord Bank of Marin v. England, 385 U.S. 99, 101 (1966); *Barnhill v. Johnson*, 503 U.S. 393, 112 S. Ct. 1386, 1389 (1992). Where the depositor is also obligated to the bank for a loan or other similar debt, the depositor and the bank have mutual obligations. The bank owes the depositor an amount equal to the balance of the account, and the depositor owes the bank the amount of his separate obligation.

It is undisputed in the present case that Citizens had a right to set off the amount due under the Note against a portion of the funds in Strumpf's account.[6] *See Mercantile*, 44 Md. App. at 44, 408 A.2d at 1049. Additionally, Citizens possessed the right of setoff against Strumpf's account by contract, pursuant to the express terms of the Note. (R. 1) (the Note).

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[6] By granting Citizens' motion for relief from the automatic stay, thereby expressly authorizing Citizens to exercise its right of setoff, the bankruptcy court concluded that Citizens had a valid right of setoff. (J.A. 29a). This ruling was not appealed by Strumpf and any issue relating to whether a valid right of setoff existed was not raised below.

B. Citizens' Setoff Right is Recognized and Preserved by the Bankruptcy Code.

1. Section 553(a) Expressly Provides that a Creditor's Right to Offset a Mutual Debt is Not Affected by the Bankruptcy Code, Except as Otherwise Provided in Sections 362 and 363.

A resolution of the question presented by this case requires the interpretation of several sections of the Bankruptcy Code. The starting point in construing any statute is the plain language of the statute. *Pennsylvania Public Welfare Dept. v. Davenport*, 495 U.S. 552, 557 (1990); *Kelly v. Robinson*, 479 U.S. 36, 43 (1986); *Consumer Product Safety Commission v. GTE Sylvania, Inc.*, 447 U.S. 102, 108 (1980). Where the statute's language is unambiguous, "the sole function of the court is to enforce it according to its terms." *Caminetti v. United States*, 242 U.S. 470, 485 (1917). *Accord Connecticut Nat'l Bank v. Germain*, 503 U.S. 249, 112 S. Ct. 1146, 1149 (1992). Separate provisions of the same act are to be given a harmonious and comprehensive meaning. *Clark v. Uebersee Finanz-Korporation, A.G.*, 332 U.S. 480, 488 (1947). Where the statutory scheme is coherent and consistent, there is no need to inquire beyond the plain language. *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 240-41 (1989). Adherence to these maxims leads to a result contrary to the one reached by the Fourth Circuit below.

Section 553 of the Bankruptcy Code expressly preserves the common law right of setoff in bankruptcy cases. It provides, in pertinent part:

> (a) Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does

> not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case. . . .

11 U.S.C. §553(a) (1988).

The preservation of the common law setoff right in bankruptcy proceedings has a long history in American bankruptcy law. *See* 4 James W. Moore & Lawrence P. King, *Collier on Bankrupcy*, ¶553.01, at 553-1 to 553-9 (15th ed. 1994) (tracing the history of the preservation of the setoff right in bankruptcy); Carmelita J. Hammon, *Setoff in Bankruptcy: Is the Creditor Preferred or Secured?*, 50 U. Colo. L. Rev. 511 (1979). The Sixth Circuit Court of Appeals succinctly articulated the rationale for the stringent preservation of this favored right: "The principle upon which the rule [of setoff] proceeds is that in case of mutual debts, it is only the balance which is the real and just sum owing by or to the bankrupt." *Prudential Ins. Co. of America v. Nelson*, 101 F.2d 441, 443 (6th Cir.), *cert. denied*, 308 U.S. 583 (1939).

Section 553 continues this tradition under the Bankruptcy Code. It was intended to carry forward the principles governing setoff that had been found in section 68 of the Bankruptcy Act of 1898, as later amended by the Bankruptcy Act of 1938. *See* H.R. Rep. No. 95-595, 95th Cong., 1st Sess. at 183-86, 377 (1977), *reprinted in*, 1978 U.S.C.C.A.N. 5787, 6143-47, 6333. By maintaining a creditor's common law right to set off the obligations of its debtor against its own debt to the debtor, §553 recognizes the injustice in permitting a creditor to obtain repayment of only a portion of the debt owed by the

debtor, while at the same time compelling the creditor to pay its full indebtedness to the debtor.

> Absent a setoff, a creditor . . . is in the worst of both worlds: it must pay its debt to the debtor in full, but is only entitled to receive a tiny fraction of the money the debtor owes it. It was to avoid this unfairness to creditors that setoffs were allowed in bankruptcy in the first place.

In re De Laurentiis Entertainment Group, Inc., 963 F.2d 1269, 1277 (9th Cir.), *cert. denied*, ___ U.S. ___, 113 S. Ct. 330 (1992). *See also* 4 *Collier on Bankruptcy*, *supra*, ¶553.01, at 553.11.

The only significant changes made in the Bankruptcy Code relating to the right to set off mutual prebankruptcy obligations are procedural; they do not alter the long-standing goal of preserving the right of setoff throughout the bankruptcy case. These changes are (i) to limit the exercise of the right of setoff by subjecting the right to the broad scope of the automatic stay of §362; and (ii) to permit the trustee or debtor in possession to use property subject to the right of setoff, under the circumstances described in §363. *See* H.R. Rep. No. 95-595, 95th Cong., 1st Sess. at 183-86, 377 (1977), *reprinted in*, 1978 U.S.C.C.A.N. 5787, 6143-47, 6333. *See also* 4 *Collier on Bankruptcy*, *supra*, ¶553.01, at 553-6 to 553-9 (discussing changes made by the Code).[7]

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[7] Section 553 also alters the treatment of claims against the debtor acquired from a third party, a situation not presented by the facts here.

2. The Only Bankruptcy Code Provisions Qualifying a Creditor's Exercise of Its Setoff Right–§§362 and 363–Do Not Eliminate the Right of Setoff.

The automatic stay of §362 is one of the fundamental protections afforded debtors by the Bankruptcy Code. It operates to provide the debtor temporary relief from the actions of creditors enumerated in §362(a). Conversely, §362 is also designed to protect creditors by ensuring that creditors with equal rights are treated equally in the repayment of debts.[8] *See* H.R. Rep. No. 95-595, 95th Cong., 1st Sess., at 340-2 (1977), *reprinted in*, 1978 U.S.C.C.A.N. 5787, 6296-97.

Section 362(a)(7) expressly provides that a creditor may not exercise his right of setoff during the pendency of the bankruptcy case without obtaining relief from the automatic stay. It states, in pertinent part:

> (a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title . . . operates as a stay, applicable to all entities, of–
>
> * * * *
>
> (7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim of the debtor. . . .

11 U.S.C. §362(a)(7) (1988).

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[8]Creditors with different rights and priorities receive different treatment under the Bankruptcy Code, just as they do outside bankruptcy. For example, a secured creditor is treated quite differently from an unsecured creditor, particularly with respect to the secured creditor's collateral. *See, e.g.*, 11 U.S.C. §§1129(b)(2)(A), 1325(a)(5) (1988). While preserving a creditor's right of setoff has the effect of paying one creditor more than the other, bankruptcy laws have provided for just this result. *See Cumberland Glass Mfg. Co. v. DeWitt*, 237 U.S. 447, 455 (1915).

Although a creditor with a common law right of setoff preserved by §553 is stayed from the exercise of that right during the bankruptcy case absent relief from the stay, §506(a) of the Code makes the creditor a secured creditor to the extent of his right:

> (a) An allowed claim of a creditor . . . that is subject to setoff under section 553 of this title, is a secured claim . . . to the extent of the amount subject to setoff . . . and is an unsecured claim to the extent that . . . the amount so subject to setoff is less than the amount of such allowed claim.

11 U.S.C. §506(a) (1988). *See In re Santoro Excavating, Inc.*, 32 B.R. 947, 950 (Bankr. S.D.N.Y. 1983). By equating setoff with a secured claim, the Bankruptcy Code recognizes that a creditor with a right of setoff is entitled to a preference over other creditors to the extent of the amount of the setoff right. *See id.*

Where the subject of the right of setoff is a bank account, the creditor's rights as a secured creditor are amplified by the special provisions of the Bankruptcy Code concerning "cash collateral." Section 363(a) defines "cash collateral" as "cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest . . . ." 11 U.S.C. §363(a) (1988).

A bank account subject to a bank's setoff right is clearly "cash collateral." As one noted authority stated,

> [t]he language of section 363(a) is intentionally broad to deal with situations where the property concerned is not strictly collateral. To illustrate, a bank stayed from setting off under section 362(a)(7) would be treated as the holder of a secured claim under section 506(a) to the extent of the deposit

account and the deposit account is considered as "cash collateral" under section 363(a).

2 *Collier on Bankruptcy, supra*, ¶363.02, at 363-16. Numerous courts are in accord. *See, e.g., Kenney's Franchise Corp. v. Central Fidelity Bank, N.A.*, 22 B.R. 747, 750 (W.D. Va. 1982); *In re Williams*, 61 B.R. 567, 571 (Bankr. N.D. Tex. 1986) (a Chapter 11 case); *In re Owens-Peterson*, 39 B.R. 186, 189 (Bankr. N.D. Ga. 1984) (a Chapter 13 case); *In re Gazelle, Inc.*, 17 B.R. 617, 620 (Bankr. W.D. Wisc. 1982).

Section 363 imposes limits on what a debtor in possession or trustee in bankruptcy may do with cash collateral. Section 363(c)(2) provides:

> (2) The trustee may not use, sell, or lease cash collateral under paragraph (1) of this subsection unless –
>
> (A) each entity that has an interest in such cash collateral consents; or
>
> (B) the court, after notice and a hearing, authorizes such use, sale, or lease in accordance with the provisions of this section.

11 U.S.C. §363(c)(2) (1988).[9] Thus, the use of cash collateral by the debtor or trustee is restricted by the terms of §363 unless the creditor consents to use of the cash collateral or the court authorizes such use. *See In re Williams*, 61 B.R. 567, 572 (Bankr. N.D. Tex. 1986). This provision exists for the protection of the secured creditor: "The protection is offered not by reason of any non-bankruptcy law limitations inherent to cash collateral but rather in recognition of the unique nature of cash collateral and the risk to the entity with an interest

[9]Section 363(c)(2) applies to debtors in possession by virtue of 11 U.S.C. §1304(b).

therein arising from consumption of the collateral in a rehabilitative effort in bankruptcy." 2 *Collier on Bankruptcy, supra*, ¶363.02, at 363-16.

The protections afforded a creditor for its cash collateral extend further. Section 363(c)(4) provides that a trustee must segregate and account for any cash collateral in the trustee's possession, custody and control. 11 U.S.C. §363(c)(4) (1988). Section 363(e) further provides in relevant part:

> Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest.

11 U.S.C. §363(e) (1988). Consistent with this restriction, a debtor proposing to use cash or cash equivalents held by a creditor with a right of setoff may be denied use of the cash without first providing adequate protection for the creditor's interest. *See, e.g., In re Hooper*, 152 B.R. 309, 310 (Bankr. D. Colo. 1993); *In re Johnson*, 136 B.R. 306, 311 (Bankr. M.D. Ga. 1991) (both holding that a debtor must demonstrate that the IRS was adequately protected before the IRS would be required to issue a tax refund check subject to IRS setoff). *See also* 2 *Collier on Bankruptcy, supra*, ¶363.06, at 363-30 to 363-35 (where cash subject to setoff is proposed to be used, adequate protection must be furnished before action is taken to use cash collateral).

Sections 362 and 363 thus provide protections, rights and limits for the debtor and the creditor with respect to the creditor's exercise of its right to set off prepetition obligations against each other. Section 362 operates to

stay the exercise of the right of setoff until the creditor has obtained the court's permission, and §363 serves to protect the creditor from losing the right as a result of the debtor's dissipation of the property securing the right. Applied to the facts of this case, §362 operated to delay the ultimate exercise of Citizens' right to set off the amount due under the Note against money in the Debtor's account. The automatic stay did not, however, eliminate Citizens' setoff right.

3. A Bank's Right to Refuse to Turn Over to a Debtor Funds on Deposit and Subject to Setoff is Expressly Recognized by Section 542(b).

A creditor's setoff right against a debtor and his bankruptcy estate is further protected by §542(b) of the Bankruptcy Code. Section 542(b) generally covers the subject of "turnover" of property of the estate; that is, when third parties holding possession of property of a bankruptcy estate must deliver the property to the trustee or debtor in possession. Section 542(b) plainly authorizes a creditor not to pay a debt to the debtor to the extent that such debt is subject to setoff:

> (b) Except as provided in subsection (c) or (d) of this section, an entity that owes a debt that is property of the estate and that is matured, payable on demand, or payable on order, shall pay such debt to, or on the order of, the trustee, *except to the extent that such debt may be offset under section 553 of this title against a claim against the debtor.*

11 U.S.C. §542(b) (1988) (emphasis added).

The operation of §542(b) is best illustrated outside the bank-depositor context. In the case of *In re Whitman*, 38 B.R. 395 (Bankr. D.N.D. 1984), a commissioned salesman was both a customer and employee of a corporation. As an employment benefit, the salesman obtained a discount on products he purchased from the corporation for personal use. Over time, the salesman purchased $4,215.01 worth of product, and in that same period earned $2,265.92 in unpaid sales commissions. After the salesman filed for bankruptcy relief, he instituted a turnover action under §542 of the Bankruptcy Code demanding that the corporation pay him his commissions. The court correctly held that, by operation of §542(b), the corporation was entitled to refuse to pay the commissions because of its right of setoff against those funds, and the debtor's turnover request was denied.

Application of §542(b) in a bank-depositor context is no different. Because the funds in a deposit account constitute a debt owed by the bank to its customer, the bank may refuse to pay that debt, *i.e.*, release the funds in the account, to the extent that it has a right of offset against the funds.

The leading bankruptcy treatise agrees with this view: "If the deposit account may be set off against a debt owed by the debtor to the bank, then turnover of the deposit account must be made *except to the extent the account may be set off against the debt under section 553.*" 4 *Collier on Bankruptcy, supra*, ¶542.03, at 542-15 (emphasis added). *Accord In re Edgins*, 36 B.R. 480, 483 (Bankr. 9th Cir. 1984); *In re Carpenter*, 14 B.R. 405, 407-08 (Bankr. M.D. Tenn. 1981). The commentators who have analyzed this issue also generally agree with this conclusion. *See* Russell J. Passamano, *Setoff in Bankruptcy: An Overview of the Mechanics*, 105 Banking L. J. 349, 358 (1988). *See also* Benjamin Weintraub & Alan N. Resnick, *Freezing the Debtor's Account: A Banker's Dilemma Under the Bankruptcy Code*, 100 Banking L. J. 316 (1983). Applied to the facts of the

instant case, §542(b) expressly permitted Citizens to refuse to turn over funds from the Debtor's account to the extent Citizens claimed a right of setoff in those funds.

C. The Interplay of the Five Relevant Bankruptcy Code Sections—§§362, 363, 506, 542 and 553—Gives Rise to a Purposeful Statutory Equilibrium Between the Competing Rights of the Debtor and the Bank Creditor to Funds in a Bank Account.

The restrictions on the exercise of the right of setoff by a creditor on the one hand, and on a debtor's ability to use and obtain a turnover of funds on the other, give rise to a purposeful statutory equilibrium appropriately described by one court as a "stalemate." *Edgins*, 36 B.R. at 483. By virtue of §362(a)(7), a creditor may not exercise its right of setoff absent relief from the automatic stay. From the debtor's perspective, §363(c)(2) restricts the debtor's use of funds that are subject to setoff and deemed cash collateral. The debtor also lacks free access to the funds because §542(b) expressly allows a creditor to refuse to pay a debt that is subject to setoff.

The Bankruptcy Appellate Panel of the Ninth Circuit in *Edgins* described the possible resolutions to this statutory equilibrium in the bank-depositor context as follows:

> This stalemate may be alleviated by either party initiating a number of alternative proceedings in the bankruptcy court. Either party might make application for a declaratory determination of whether the frozen account is security by virtue of Section 506(a) and thus subject to a right of setoff under Section 553. The creditor might bring an action for relief from the automatic stay for the purpose of asserting and exercising its security interest and right to setoff. The debtor might bring a motion for use of the security as cash collateral under 11 U.S.C. Section 363. Any of these methods could be pursued by motion and in a shortened time frame, given an emergency. The bankruptcy code does not specify which should be used nor whether the creditor or the debtor should initiate action to break what appears to be a statutory logjam.

Edgins, 36 B.R. at 483. *See also* Weintraub & Resnick, *supra*, at 3-4.

In the present case, the statutory stalemate took effect upon the Debtor's bankruptcy filing. The parties' respective obligations relating to the Debtor's bank account and the Note were created prebankruptcy and were unquestionably mutual. *See supra* at 3-4. Citizens' preexisting common law and contractual right to set off against the Debtor's bank account an amount equivalent to what the Debtor owed Citizens under the Note was preserved under §553. While Citizens was stayed from exercising its right of setoff without bankruptcy court approval, Citizens was entitled under §542(b) to decline to pay the Debtor from his account an amount equal to the sum outstanding on the Note, absent a court order to the contrary.

II.
THE IMPOSITION OF AN ADMINISTRATIVE HOLD DOES NOT VIOLATE THE AUTOMATIC STAY.

A. An Administrative Hold is Not a Setoff and Does Not Violate Section 362(a)(7).

The Fourth Circuit's analysis below focused on the propriety and effect of the administrative hold placed on the account by Citizens. As explained below, the mere imposition of an administrative hold or "freeze" such as the one employed by Citizens is not an act of setoff as contemplated by §362(a)(7), because it is not the result of an intent to set off money in a debtor's account and does not represent affirmative action to effectuate that intent.

While many creditors with a right of setoff may exercise their rights under §542(b) by simply informing a debtor that they choose not to pay their debt subject to a setoff, a financial institution does not have the luxury of simplicity. Financial institutions face significant communicative, technological and geographical difficulties in manifesting an intent and implementing a decision not to pay. Funds in a demand deposit or checking account in most financial institutions are easily accessible in various ways. The account holder may write a check, which comes to the bank through collection channels from another institution or is personally presented by the individual or entity to whom the check is drawn. The account holder may appear in person and make a withdrawal over the counter at any number of bank branches. The depositor may also access funds from automated teller machines all over the country, if not the world. The funds in a bank account can be disbursed to a third party pursuant to an agreement with the bank, for example, in a monthly "bill pay" arrangement. Bank

funds may also be transmitted by electronic transfer in response to a request from the depositor or a third party.

A financial institution must have a mechanism to communicate its decision to exercise its right under §542(b) not to permit withdrawal of funds subject to setoff to multiple branches, automated teller machines, and others with responsibility for administering bank accounts. The solution is the administrative hold or "freeze." The hold is accomplished by electronically coding a financial institution's computers to restrict access to specific funds, and is the most efficient procedure—indeed, the *only* procedure—by which a bank may ensure institution-wide compliance with its internal account-related directives. Ultimately, it is nothing more than a bank's means of communicating to various bank personnel and computers its intent not to pay its debt to its depositor.

Because the timing of a setoff may affect priorities among competing creditors, some states have developed precise tests to determine just when a setoff has occurred. No reported Maryland case has directly addressed this question. However, the predominant and better view among jurisdictions that have formulated such tests requires evidence of an intent to set off coupled with action effectuating that intent. In the leading case of *Baker v. Nat'l City Bank of Cleveland*, the Sixth Circuit stated:

> [T]he act of setoff is not complete until three steps have been taken: (1) the decision to exercise the right, (2) some action which accomplishes the setoff and (3) some record which evidences that the right of setoff has been exercised.

511 F.2d 1016, 1018 (6th Cir. 1975). The test for setoff articulated in *Baker* has been cited repeatedly with

approval. *See, e.g., Horton Dairy, Inc. v. United States*, 986 F.2d 286, 291 (8th Cir. 1993); *United States v. Central Bank of Denver*, 843 F.2d 1300, 1310 (10th Cir. 1988); *In re Saugus Gen. Hosp., Inc.*, 698 F.2d 42, 47-48 (1st Cir. 1983). *See also* 4 *Collier on Bankruptcy, supra*, ¶553.02, at 553-12.[10]

The language of §542(b) supports the distinction between declining to pay a debt that is subject to setoff and the actual exercise of the setoff right. Section 542(b) states that an entity that owes a debt to the debtor must pay that debt except to the extent that such debt "*may* be offset." 11 U.S.C. §542(b) (1988) (emphasis added). The quoted language contemplates that the right of setoff need not yet have been exercised. The Bankruptcy Code thus implicitly recognizes a distinction between declining to pay a debt that is subject to setoff, and the actual exercise of the setoff right. *In re Moreira*, 173 B.R. 965, 966-67 (Bankr. D. Mass. 1994); *In re Carpenter*, 14 B.R. 405, 407 (Bankr. M.D. Tenn. 1981).

Presumably because some courts have failed to make the critical distinction between preserving and exercising the right of setoff, the most recent report of the National Bankruptcy Conference's Code Review Project[11] sug-

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[10] "A setoff occurs only when the creditor has sufficiently demonstrated an intent to set off. The setoff does not arise automatically merely because the creditor and the debtor have mutual debts, but only occurs where there has been a deliberate, overt action showing that the creditor has exercised its right of setoff."

[11] The National Bankruptcy Conference is a voluntary, nonprofit organization of about sixty lawyers, law professors, and bankruptcy judges who have achieved scholarly distinction in the field of bankruptcy law. Its purpose is to study in a continuing program the operation of bankruptcy and related laws and to consult with Congress from time to time on needed revisions. The National Bankruptcy Conference's Code Review Project, *Foreword* to Reforming the Bankruptcy Code at i (1994).

gested that §542(b) be clarified to ensure that it is interpreted and followed in the bank-depositor context consistent with its operation in the usual nonbank context. The report stated:

> Language should be added emphasizing that the right not to pay over a debt to the extent it is subject to a setoff right (a provision already in section 542(b)) means that a party may refuse to pay over such debt (*or "freeze" an account that represents a debt owing to the debtor*) without violating the automatic stay.

The National Bankruptcy Conference's Code Review Project, Reforming the Bankruptcy Code 256 (1994) (emphasis added). The Conference recognized that courts which have determined that the imposition of an administrative hold violates the automatic stay have either failed to appreciate that deposit accounts represent debts owed by the bank or have failed "to recognize the existence of section 542(b)." *Id.* at 257.

In the instant case, Citizens' actions clearly stopped short of accomplishing a setoff. Citizens filed its motion seeking relief from the stay under §362(d), seeking permission to exercise its setoff right, contemporaneously with its imposition of the administrative hold on a portion of Strumpf's account. In doing so, Citizens evidenced its intent to delay the exercise of its right of setoff pending bankruptcy court approval. The balance of the account was not reduced by the amount of setoff, and Citizens in all respects acted in a manner evidencing that a setoff had not been taken.

B. An Administrative Hold is Not an Act to Exercise Control Over Property of the Estate.

In addition to staying a creditor's exercise of the right of setoff, the automatic stay prohibits creditors from taking acts to exercise control over property of the bankrupt's estate. Section 362(a)(3) states in pertinent part:

> (a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title . . . operates as a stay, applicable to all entities, of–
>
> * * * *
>
> (3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate.

11 U.S.C. §362(a)(3) (1988).[12] The imposition of an administrative hold on a bankrupt depositor's account does not violate §362(a)(3) because the funds in the account are property of the bank, not the estate.

When a bank depositor files for bankruptcy relief, his claim against the bank, not the money in his account, becomes the property of the estate under 11 U.S.C. §541(a)(1). *See Bank of Marin v. England*, 385 U.S. 99, 101 (1966); *Barnhill v. Johnson*, 503 U.S. 393, 112 S. Ct. 1386, 1389 (1992) ("[a] person with an account at a bank enjoys a claim against the bank for funds in an amount equal to the account balance."). This is because the deposits in the account are property of the bank, not the depositor. *See supra* at 13-14; *Keller v. Fredericktown*

[12] Although the Fourth Circuit in *Strumpf* did not consider other provisions of §362(a), some other courts have found the imposition of an administrative hold to be a violation of §362(a)(3). *See, e.g., In re Wicks*, 176 B.R. 695 (Bankr. E.D.N.Y. 1995).

Sav. Inst., 193 Md. 292, 296, 66 A.2d 924, 926 (1949) ("the bank owns the money deposited, subject to the right of the depositor to draw on it."). Where a bank asserts a right of setoff and freezes the debtor's account, the debtor's claim to the bank account (*i.e.*, the estate's property) is not affected in any way by the imposition of the hold, except to the extent permitted by §542(b). Accordingly, an administrative hold, by which a bank ensures that it does not pay its debt to the debtor pending determination of the bank's setoff right, is not an exercise of control over property of the estate in violation of §362(a)(3). *In re Lough*, 163 B.R. 586, 588 (Bankr. D. Idaho 1994); *In re Air Atlanta, Inc.*, 74 B.R. 426, 427 (Bankr. N.D. Ga.), *aff'd*, 81 B.R. 724 (N.D. Ga. 1987).

III.
THE FOURTH CIRCUIT'S ANALYSIS IN *STRUMPF* IS INCOMPLETE AND FLAWED.

The Fourth Circuit made five fundamental mistakes in concluding that an administrative hold on bank deposit funds subject to setoff was a violation of the automatic stay. The lower court (1) ignored the effect of §§363, 506(a), and 542(b) of the Bankruptcy Code; (2) failed to recognize that the bank deposit funds belonged to Citizens, not the Debtor; (3) in effect erroneously concluded that the automatic stay was intended to defeat a creditor's right of setoff, despite other provisions of the Bankruptcy Code and legislative history expressly to the contrary; (4) incorrectly equated an administrative hold to a setoff; and (5) relied on precedent from other jurisdictions having little, if any, relevance to the present case and which is otherwise unpersuasive.

A. Failure to Address All the Relevant Code Sections

The Fourth Circuit panel did not consider the interplay between the five different sections of the Bankruptcy Code which bear directly on the issue presented here. Instead, the lower court's opinion focused only on §§362(a)(7) and 553. In doing so, the Fourth Circuit ignored the impact of §§363, 506(a) and 542(b).[13]

In a remarkably prescient article, two of the foremost bankruptcy commentators predicted that the precise outcome reached by the Fourth Circuit would result from its flawed analysis:

> The seemingly uncomplicated question of whether a bank owed money by its customer may temporarily freeze the customer's account upon learning of its bankruptcy cannot be answered adequately without considering the interplay of several Code provisions. When only Sections 553(a), recognizing the right of setoff, and 362(a)(7), applying the automatic stay to setoffs are considered . . . an erroneous conclusion is reached which prohibits the freezing of funds without court approval.

Weintraub & Resnick, *supra*, at 324. The Fourth Circuit did not appreciate that under §542(b) Citizens had a right to refuse to pay its debt to the Debtor, and that Citizens' declination to pay its debt to Strumpf did not equate to a setoff or an act to exercise control over property of the estate.

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[13]The Fourth Circuit did mention §§506(a) and 542(b) in passing in a footnote, but did not analyze the relevance of these sections to this case. *Strumpf*, 37 F.3d at 157 n.*.

B. Failure to Recognize the Debtor-Creditor Nature of Citizens' Account Relationship With the Debtor

Nowhere in the *Strumpf* opinion did the Fourth Circuit discuss the debtor-creditor relationship between Citizens and the Debtor that was created upon Strumpf's first deposit into his account. Rather, the *Strumpf* court seemingly held the common lay perspective that the money in the Debtor's account was the property of the Debtor, merely held by Citizens for his use. Premised on this misconception, the Fourth Circuit concluded that the Debtor had a right to withdraw all funds in his account while his bankruptcy case was pending: "Whether the creditor actually offsets the debtor's account or places a hold on the debtor's account, both effectively deprive the debtor of the use of the funds pending the outcome of the motion for relief from the stay." *Strumpf*, 37 F.3d at 158 (citation omitted).

C. Erroneous Conclusion that Section 362(a) Was Intended by Congress to Defeat the Right of Setoff

The Fourth Circuit's decision wrongly suggests that Congress intended a debtor to have the ability to defeat a creditor's right of setoff by moving quickly to withdraw funds before the creditor can obtain relief from the automatic stay. In the words of the Fourth Circuit, "[w]hile the banker's dilemma may allow a debtor to defeat a creditor's right of setoff, the clear and unambiguous language of 362(a) produces this result." *Strumpf*, 37 F.3d at 159.

The automatic stay was designed to be just that—a *stay*. While the Code itself is clear enough on this point, the legislative history answers any doubt on the point:

> Paragraph (7) stays setoffs of mutual debts and credits between the debtor and creditors. As with all other paragraphs of subsection (a), this paragraph does not affect the rights of creditors. It simply stays its enforcement pending an orderly examination of the debtor's and creditor's rights.

H.R. Rep. No. 95-595, 95th Cong., 1st Sess. at 342 (1977), *reprinted in*, 1978 U.S.C.C.A.N. 5787, 6298; S. Rep. No. 95-989, 95th Cong., 2nd Sess. at 51 (1978), *reprinted in*, 1978 U.S.C.C.A.N. 5787, 5837. The automatic stay thus was intended to serve as a shield, not a sword capable of severing interested parties from their vested rights:

> The shield of 11 U.S.C. Section 362, which is procedural and vests no intrinsic interest in property to the estate, should not be used as a sword to divest other parties of legitimate interests in property particularly where the debtor has the knowledge and means to bring whatever claim he may have for use of the funds on for prompt hearing.

Edgins, 36 B.R. at 484.

The Fourth Circuit's interpretation of §362(a) renders §§363(c)(2) and 542(b) nullities, and §553 meaningless, as applied to depository institutions. Such an interpretation violates the fundamental maxim that a statute must, if possible, be construed so that every word has some operative effect. *See United States v. Nordic Village, Inc.*, 503 U.S. 30, 36 (1992). *See also Weinberger v. Hynson, Westcott and Dunning, Inc.*, 412 U.S. 609, 631-32 (1973) (separate provisions of the same act are to be given a harmonious and comprehensive meaning, citing *Clark v. Uebersee Finanz-Korporation, A.G.*, 332 U.S. 480, 488 (1947)).

D. Incorrectly Equates an Administrative Hold With a Setoff

The Fourth Circuit incorrectly held that an administrative hold is tantamount to the exercise of a right of setoff and, thus, is violative of §362(a)(7). *Strumpf*, 37 F.3d at 158. As demonstrated above, *see supra* at 26-29, the imposition of an administrative hold is not a setoff, nor should it be considered tantamount to a setoff. It is the only effective means by which a financial institution may decline to pay its debt to the depositor pursuant to §542(b).

By placing an administrative hold, a financial institution does not change the positions of the parties with respect to their interests in the frozen account. A legal stalemate already exists upon the debtor's bankruptcy filing quite apart from any freeze. The hold does not improve or worsen the bank's position: the bank may not set off the funds in the account, yet it retains the right to use the funds since they remain property of the bank. The hold does not improve or worsen the debtor's position: the debtor may not use the funds, but maintains a claim to the funds. The hold merely preserves the *status quo* until such time as the bankruptcy court can determine the respective rights of the parties.[14] *See Edgins*,

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[14] If the imposition of an administrative hold is accompanied by a motion for relief from the automatic stay, the bankruptcy court will determine the respective rights of the parties in relatively short order. *See* 11 U.S.C. §362(e) (1988); 11 U.S.C.A. §362(e) (1993 & 1995 Supp.). The administrative hold ensures that the *status quo* is preserved during this relatively brief period.

36 B.R. at 484 ("The bank in the case at bar has maintained the status quo without taking action to collect or recover a claim against the debtor. It has simply deferred payment of the funds pending the outcome of any proceedings brought by it or the debtor to determine their use and ownership."); *Stann v. Mid American Credit Union*, 39 B.R. 246, 248 (D. Kan. 1984); *In re Learn*, 95 B.R. 495, 496 (Bankr. N.D. Ohio 1989); *In re Bass Mechanical Contractors, Inc.*, 84 B.R. 1009, 1022-23 (Bankr. W.D. Ark. 1988).

E. Misplaced Reliance Upon *Reynolds*, *Norton*, and *Rinehart*

In equating an administrative hold to a setoff, the Fourth Circuit placed significant reliance upon *United States v. Reynolds*, 764 F.2d 1004 (4th Cir. 1985), *United States v. Norton*, 717 F.2d 767 (3rd Cir. 1983), and *Small Business Admin. v. Rinehart*, 887 F.2d 165 (8th Cir. 1989). *See Strumpf*, 37 F.3d at 158.[15] That reliance was misplaced.

The Fourth Circuit's adherence to the reasoning employed in these three cases is partially attributable to the court's apparent misunderstanding of the nature of a deposit account and the effect of the relevant Bankruptcy Code provisions, especially §542(b). This is

[15]The Fourth Circuit also relied upon *In re Penn Central Transportation*, 453 F.2d 520 (3rd Cir. 1971), *cert. denied*, 408 U.S. 923 (1972). *Strumpf*, 37 F.3d at 158. *Penn Central* involved an entirely different, although facially similar, set of concerns from the present case. There, the defendant banks actually set off debts owed them by a railroad undergoing reorganization, in violation of a court order expressly prohibiting them from taking such action. The banks' appeal focused on the jurisdictional authority of the reorganization court to enter the order prohibiting set off. *Id.* at 521-23. *Penn Central* thus has no relevance here.

hardly surprising, given that all three of the earlier cases suffered from similar shortcomings. The courts in *Norton*, *Reynolds*, and *Rinehart* focused their attentions on the effect of withholding payment of money to the debtor and the similarity of that effect to the consequences of a setoff.[16] None of these cases considered the effect of §542(b) and the rights of the creditor agencies to decline to pay debts subject to setoff. Without understanding that the debtors did not have a unilateral right to access the funds held by the creditor agencies to begin with, it is perhaps understandable that these courts incorrectly perceived the freezes imposed as violations of the automatic stay.

The outcome in *Rinehart* also may have been influenced by the fact that the creditor in the case, the Small Business Administration ("SBA"), attempted to retain possession of a check, which it erroneously received postpetition, that was made payable to the debtors by the Department of Agriculture. The SBA gave the debtors no notice that it had come into possession of the check. *Rinehart*, 889 F.2d at 168. *Norton* also is distinguishable because the creditor there, the IRS, had withheld the debtor's tax refund without contemporaneously requesting relief from the stay, apparently intending to withhold the refund until the case was closed.[17] In both of

[16]It is noteworthy that *Norton* relied upon *Penn Central*, a pre-Code case which did not involve §§363 or 542. *Norton*, 717 F.2d at 773. *Reynolds* liberally adopted the logic of *Norton*, *Reynolds*, 764 F.2d at 1006-07, and *Rinehart* liberally adopted the logic of both *Norton* and *Reynolds*. *Rinehart*, 887 F.2d at 168-69. The *Strumpf* opinion appears to be a continuation of this pattern of reliance on precedent rather than independent analysis of the relevant Bankruptcy Code sections.

[17]It is not clear why the IRS has had difficulty, along with financial institutions, in exercising its setoff rights in bankruptcy.

[footnote continued]

these cases, the government's conduct was susceptible to being viewed by the bankruptcy court as closely equivalent to a setoff.

Furthermore, the relevance of *Norton* as precedent in any jurisdiction but Pennsylvania must be questioned. *Norton* applied Pennsylvania law to determine when a setoff of federal tax liabilities occurs. *Norton*, 717 F.2d at 772. Pennsylvania employs an unusual rule of "automatic setoff," under which a setoff is said to occur as a matter of law at the moment that the creditor's claim matures. *See Pittsburgh Nat'l Bank v. United States*, 657 F.2d 36, 38 (3rd Cir. 1981). Under the "automatic setoff" doctrine of Pennsylvania, the maturation of a debt is deemed to "automatically" cause the setoff by operation of law. *Id.* Since Maryland law, which has no such setoff doctrine, is controlling here, *Norton* is not persuasive authority in this case.

One explanation may be that IRS cases sometimes involved conduct viewed to be inequitable by the bankruptcy court, and the court exercised its equity powers to restrain the IRS from exercising its setoff rights. *See, e.g., In re Cascade Roads, Inc.*, 34 F.3d 756, 763-64 (9th Cir. 1994) (the bankruptcy court found the case "replete with inequitable conduct on the part of the Government"). This explanation, however, only goes so far. For example, in the Eastern District of Pennsylvania, the same bankruptcy judge acknowledged the IRS's right to retain funds to the extent of its setoff right in one case, citing 11 U.S.C. §542(b), *see In re Powers*, 28 B.R. 86 (Bankr, E.D. Pa. 1983) (IRS motion to lift stay granted), while in another case the IRS was held in contempt for withholding payment of an income tax refund to the debtor, *see In re Mealey*, 16 B.R. 800 (Bankr. E.D. Pa. 1982).

F. The Fourth Circuit's Interpretation of the Bankruptcy Code Raises a Serious Constitutional Issue Which Should Be Avoided.

It is a cardinal principle of statutory interpretation that "where an otherwise acceptable construction of a statute would raise serious constitutional problems, the Court will construe the statute to avoid such problems unless such construction is plainly contrary to the intention of Congress." *Edward J. DeBartolo Corp. v. Florida Gulf Coast Bld. & Constr. Trades Council*, 485 U.S. 568, 575 (1988). This approach reflects the concern that courts should not needlessly confront constitutional issues and recognizes that a court will assume that Congress did not intend to infringe upon constitutionally protected liberties. *Id.*

The Fifth Amendment to the United States Constitution provides, in part: "No person shall be . . . deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation." U.S. Const. amend. V. As discussed below, the Fourth Circuit's interpretation of §362(a)(7) may be read to effect an unconstitutional taking of a bank's property—the right of setoff—without adequate compensation. However, this Court need not wrestle with the constitutionality of the Bankruptcy Code as interpreted by the *Strumpf* decision, because the correct and harmonious construction of all the relevant Code sections raises no such constitutional issue.

The right of setoff is similar to a secured creditor's interest in its collateral. Like a mortgage or other security interest, the right of setoff enables a creditor to secure the payment of a debt and to satisfy the debtor's obligation by permitting the creditor to retain funds that he otherwise would be obligated to pay to the debtor. *See*

Barrier v. Marine Midland Trust Co., 263 Md. 596, 607, 284 A.2d 418, 424 (1971) (the right of setoff is an exercisable right that is an incident to the remedy to secure payment of a debt). This similarity between the right of setoff and other types of security interests has been recognized by §506(a) of the Bankruptcy Code, which treats a claim of a creditor that is subject to setoff as a "secured claim" to the extent of the amount subject to setoff. *See supra* at 19.

This Court has recognized the rights of secured creditors to be property interests entitled to Fifth Amendment protection. *See United States v. Security Indus. Bank*, 459 U.S. 70, 74-76 (1982); *Armstrong v. United States*, 364 U.S. 40, 44 (1960) (recognizing protected property interest in materialman's lien under state law); *Wright v. Union Central Life Ins. Co.*, 311 U.S. 273, 279-81 (1940); *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 594 (1935) (mortgagee's rights were property interests protected by the Fifth Amendment). The right of setoff likewise should be recognized as a protected property right.

Congress' bankruptcy power under Art. I, §8, clause 4 of the Constitution is subject to the Fifth Amendment's prohibition against the taking of private property without compensation. As stated in by this Court in *Security Industrial*:

> [H]owever "rational" the exercise of the bankruptcy power may be, that inquiry is quite separate from the question whether the enactment takes property within the prohibition of the Fifth Amendment.

459 U.S. at 75. *See also Radford*, 295 U.S. at 589 ("The bankruptcy power, like the other great substantive powers of Congress, is subject to the Fifth Amendment."). Under the Fourth Circuit's interpretation in *Strumpf*, §362(a)(7) may be read to deprive banks of their constitutionally protected property interest in the right of setoff without adequate compensation.

The governmental action in this case, the enactment of §362(a)(7), as interpreted by the Fourth Circuit, would result in the virtual elimination of banks' reasonable expectations relating to the right of setoff.[18] Without the ability to place an administrative freeze on the debtor's account, banks essentially would be compelled to permit the debtor to withdraw funds on deposit (*i.e.*, pay over the debt subject to the bank's right of setoff to the estate), even though those funds secure the debtor's obligations to the bank and represent a debt that the bank may expressly decline to pay under §542(b). Such an interpretation of §362(a)(7) would raise a serious question as to whether the Code operates as an unconstitutional taking without adequate compensation or protection. *See generally Security Industrial*, 459 U.S. at 75-78 (finding governmental action of bankruptcy code destroying property rights of secured party to be an unconstitutional taking). This constitutional issue can and should be avoided by this Court's adherence to the plain language of the Code and the harmonious interpretation of §362(a)(7) with §§553 and 542(b).

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[18] The right of setoff has been embodied in every bankruptcy statute this nation has had, and creditors—particularly banks—have long acted in reliance on it. *In re Applied Logic Corp.*, 576 F.2d 952, 958 (2d Cir. 1978).

IV.

ALLOWING A BANK CREDITOR TO IMPOSE AN ADMINISTRATIVE HOLD PENDING DETERMINATION BY THE BANKRUPTCY COURT OF THE BANK'S SETOFF RIGHT IS CONSISTENT WITH THE POLICY GOALS OF THE BANKRUPTCY CODE.

A. Under *Strumpf*, the Extraordinary Measure of *Ex Parte* Relief Will Become Routine.

The *Strumpf* decision leaves banks with only one method of attempting to prevent the dissipation of the funds to which they claim a right of setoff: initiating immediate *ex parte* litigation in the bankruptcy court upon the first notice that a customer has filed for bankruptcy relief. If banks are required to go immediately into court upon the suspicion that the debtor might attempt to defeat the bank's setoff right, the bankruptcy court system will suffer from a significant increase in frantic litigation and financial institutions and debtors alike will be forced to incur greater expense in legal representation. Even courts that advocate this approach recognize its inherent drawbacks. *See In re Homan*, 116 B.R. 595, 605 (Bankr. S.D. Ohio 1990) ("This court has no desire to add additional proceedings to its existing docket, nor to increase the litigation expenses of parties in Chapter 13 cases"). Under the Fourth Circuit's holding in *Strumpf*, requests for emergency relief will become routine in federal bankruptcy courts.

Ex parte litigation, however, will not provide financial institutions with complete protection and is not a meaningful substitute for an administrative hold. If banks are denied the ability to freeze funds in which they claim a right of setoff, they must move for *ex parte* protection immediately upon becoming aware of the commencement of the bankruptcy case. Where a depositor sends

notice of his bankruptcy filing, or the bank learns of the filing through a notice to creditors, prior to the depositor's withdrawal of his funds, *ex parte* relief may be effective. However, if the bank learns of the filing contemporaneously with a request for turnover of the funds, *ex parte* action would not be effective. *See In re Moreira*, 173 B.R. 965, 968 (Bankr. D. Mass. 1994). If the request for turnover is in the form of an over-the-counter withdrawal, the bank cannot stall its depositor while its attorneys run into court.[19] The same is true for automated teller withdrawals, electronic transfer requests, automatic bill pay arrangements, and other instantaneous means by which funds are withdrawn from a bank account. If the request for turnover comes in the form of a check, the bank must have its attorneys and the judicial system act within the statutory midnight payment deadline for such instruments. *See In re Patterson*, 967 F.2d 505, 511 (11th Cir. 1992) (discussing the speed with which a bank must act to obtain *ex parte* relief under the midnight payment deadline). If *ex parte* relief is the only means available to a bank to protect its rights, the bank thus faces a substantial possibility of having no protection whatsoever.

Furthermore, banks deprived of the ability to protect their security in the event of a customer's bankruptcy (or faced with the prospect of expensive *ex parte* litigation)

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[19] Depending on the account type, for example, a certificate of deposit, a bank may have a contractual or other right to delay payment to its depositor. However, if the account is a standard checking account, like Strumpf's, or a demand deposit account, in the usual course of business a bank must pay its depositor immediately.

will have a strong incentive to accomplish setoff before the prospective debtor files a bankruptcy petition. The adoption of an interpretation of the Bankruptcy Code which encourages banks to set off debts prior to bankruptcy filings can only lead to a worsening of the financial positions of their customers, thereby possibly necessitating, or at least hastening, a bankruptcy filing.

B. *Strumpf* May be Read as Requiring All Creditors to Turn Over Property Subject to a Setoff Right Upon Demand.

By denying a bank the right to impose an administrative hold, the Fourth Circuit in *Strumpf* effectively held that a bank cannot independently exercise its choice under §542(b) not to turn over property in which it claims a right of setoff. A bank must immediately turn over the subject funds (by, for example, permitting a withdrawal or honoring a check) or violate §362(a). The logic of *Strumpf*, if adopted by this Court, necessarily would apply outside of the bank-depositor context.

Under the intepretation adopted by the Fourth Circuit, any debtor could demand immediate payment of a debt owed to him by a creditor, despite the creditor's assertion of a right of setoff. For example, an impecunious debtor, "B", has an outstanding, mature and unsecured debt of $10,000.00 owing to a creditor, "A", and A owes B $7,500.00. Both obligations arose prior to B's bankruptcy filing and are unquestionably mutual. Under *Strumpf*, B may approach A and demand immediate payment of the $7,500.00 debt (the equivalent of a withdrawal demand). A would not be able to decline to pay and seek relief from the automatic stay from the bankruptcy court to set off the $7,500.00 against B's $10,000.00 debt. Instead, A would be required to turn

over the $7,500.00 to B, and be relegated to receive from B's bankruptcy estate a prorated distribution of funds available for general creditors, which often is little or nothing. The injustice is obvious: A has been forced to pay B, but B, who is bankrupt, may end up paying little or nothing of his $10,000.00 debt to A. Thus, B, under the decision below, would be able to use the Bankruptcy Code to divest the creditor, A, of A's setoff right for B's own enrichment.

In a perfect world, the statutory stalemate between a bank creditor and a debtor which is created upon the debtor's bankruptcy filing, *see supra* at 24-25, should ensure that cash collateral is not dissipated. *See in re Wildcat Constr. Co., Inc.*, 57 B.R. 981, 985-86 (Bankr. D. Vt. 1986) ("Since, if the bank is right about the status of the funds it is holding in the debtor's accounts, the debtor may not use this cash collateral in any event, freezing the accounts hardly seems necessary. . . . We refuse to presume either that most debtors are profligate or that most banks are avaricious."). However, this is not a perfect world and harsh reality requires, and the Code permits, a bank to be allowed to impose an administrative hold on a debtor's account. As one commentator noted:

> If this were Camelot, these provisions of the Bankruptcy Code [§§ 362(a), 363, 506(a), 542(b), and 553] would, by themselves, impose the "freeze." Bankers would not put administrative holds on debtors' bank accounts and debtors would not attempt to withdraw funds from the account without the bank's permission or a court order obtained upon a showing of adequate protection.

Paul S. Groschadl, *"Freezing" the Debtor's Bank Account: A Violation of the Automatic Stay?*, 57 Am. Bankr. L. J. 75, 77 (1983).

If denied the ability to use a temporary hold, a financial institution would have no means of preventing its depositor from drawing on his account. As noted in the *Edgins* case:

> Creditors with a valid right of setoff under 11 U.S.C. Section 553 would be required to turnover to the debtor funds subject to setoff and thereafter attempt to obtain an order from the court to preclude the debtor from improvidently dissipating the funds. *This will, all too often, be an attempt to lock the barn door after the horse has been stolen.*

Edgins, 36 B.R. at 484 (emphasis added). A setoff against an account with no funds is a meaningless act, and no effective remedy exists by which a creditor can retrieve the improperly removed funds. *See Williams*, 61 B.R. at 575.[20] In view of the extreme liquidity of funds on deposit, "permitting the temporary freeze serves to give banks needed protection against the immediate dissipation of its cash collateral and resulting destruction of its right of setoff before it has an opportunity to be heard in a bankruptcy court." Weintraub & Resnick, *supra*, at 324.

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[20] "Once cash collateral has been dissipated and spent, court-fashioned sanctions such as retroactive adequate protection, appointment of a Chapter 11 trustee or prohibitions against the further use of cash collateral can be hollow victories for a secured creditor and do not rise to the level of a 'remedy.' This is especially true where all remaining property of the estate is encumbered and the cash which has been spent without permission cannot be replaced." *Id.* As a legal matter, a bank's release of funds may be viewed as a waiver and extinguish the bank's right of setoff. *See* Uniform Commercial Code §9-306(2) (1978). *See also, In re Archer*, 34 B.R. 28, 30 (Bankr. N.D. Tex. 1983) (release of funds could extinguish setoff rights although monies constitute cash collateral, but holding that no waiver occurred).

The facts of this case vividly demonstrate the consequences of depriving a financial institution of its right to freeze a bank account pursuant to §542(b). Citizens initiated the process of determining the parties' competing rights in the funds in the Debtor's account by moving for relief from the automatic stay. (J.A. 15a). The Bank imposed an administrative hold due to its concern that if the account was not frozen Citizens later would have nothing to set off. Only *after* Citizens had requested the bankruptcy court to grant relief did Strumpf move to force Citizens to turn over the funds in which Citizens claimed a setoff right.[21] (J.A. 23a); (R. 1) (Strumpf's motion seeking release of administrative hold and turnover of funds). Ironically, althought the bankruptcy court heard Citizens' motion for relief first, and later heard Strumpf's motion for contempt, the court ruled on the contempt motion and found Citizens in contempt *before* allowing it to exercise its valid right of setoff. (J.A. 27a, 29a). As Citizens predicted, by the time the bankruptcy court subsequently ruled on Citizens' motion, Citizens' cash colateral was gone. The relief from the automatic stay granted by the bankruptcy court to Citizens was a meaningless and Pyrrhic victory. A right of setoff without anything to set off against is "worth little more than the book in which it is found." *In re Davis*, 889 F.2d 658, 662 (5th Cir. 1989), *cert. denied*, 495 U.S. 933 (1990).

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[21] Of course, a motion for turnover under §542 is one of the proper methods by which a debtor can obtain authorization to use funds claimed by a creditor under a setoff right. *See Edgins*, 36 B.R. at 483 (discussing the various methods parties can use to break the "statutory logjam"). A debtor who genuinely needs the funds for his own use may well be the party who first petitions the bankruptcy court to determine the respective rights involved.

CONCLUSION

The decision of the Fourth Circuit should be reversed and the case remanded for entry of the original Order issued by the district court.

Respectfully submitted,

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APPENDIX

11 U.S.C. §362 (1988)

(a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1970 (15 U.S.C. 78eee(a)(3)), operates as a stay, applicable to all entities, of –

(1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;

(2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;

(3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;

(4) any act to create, perfect, or enforce any lien against property of the estate;

(5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;

(6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;

(7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and

(8) the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor.

* * *

(d) On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or continuing such stay –

(1) for cause, including the lack of adequate protection of an interest in property of such party in interest; or

(2) with respect to a stay of an act against property under subsection (a) of this section, if –

(A) the debtor does not have an equity in such property; and

(B) such property is not necessary to an effective reorganization.

(e) Thirty days after a request under subsection (d) of this section for relief from the stay of any act against property of the estate under subsection (a) of this section, such stay is terminated with respect to the party in interest making such request, unless the court, after notice and a hearing, orders such stay continued in effect pending the conclusion of, or as a result of, a final hearing and determination under subsection (d) of this section. A hearing under this subsection may be a preliminary hearing, or may be consolidated with the final hearing under subsection (d) of this section. The court

shall order such stay continued in effect pending the conclusion of the final hearing under subsection (d) of this section if there is a reasonable likelihood that the party opposing relief from such stay will prevail at the conclusion of such final hearing. If the hearing under this subsection is a preliminary hearing, then such final hearing shall be commenced not later than thirty days after the conclusion of such preliminary hearing.

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11 U.S.C. §363 (1988)

(a) In this section, "cash collateral" means cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property subject to a security interest as provided in section 552(b) of this title, whether existing before or after the commencement of a case under this title.

* * *

(c)(1) If the business of the debtor is authorized to be operated under section 721, 1108, 1304, 1203, or 1204 of this title and unless the court orders otherwise, the trustee may enter into transactions, including the sale or lease of property of the estate, in the ordinary course of business, without notice or a hearing, and may use property of the estate in the ordinary course of business without notice or a hearing.

(2) The trustee may not use, sell, or lease cash collateral under paragraph (1) of this subsection unless –

(A) each entity that has an interest in such cash collateral consents; or

(B) the court, after notice and a hearing, authorizes such use, sale, or lease in accordance with the provisions of this section.

(3) Any hearing under paragraph (2)(B) of this subsection may be a preliminary hearing or may be consolidated with a hearing under subsection (c) of this section, but shall be scheduled in accordance with the needs of the debtor. If the hearing under paragraph (2)(B) of this subsection is a preliminary hearing, the

court may authorize such use, sale, or lease only if there is a reasonable likelihood that the trustee will prevail at the final hearing under subsection (e) of this section. The court shall act promptly on any request for authorization under paragraph (2)(B) of this subsection.

(4) Except as provided in paragraph (2) of this subsection, the trustee shall segregate and account for any cash collateral in the trustee's possession, custody, or control.

(d) The trustee may use, sell, or lease property under subsection (b) or (c) of this section only to the extent not inconsistent with any relief granted under section 362(c), 362(d), 362(e), or 362(f) of this title.

(e) Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest.

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11 U.S.C. §506 (1988)

(a) An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.

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11 U.S.C. §542 (1988)

(a) Except as provided in subsection (c) or (d) of this section, an entity, other than a custodian, in possession, custody, or control, during the case, of property that the trustee may use, sell, or lease under section 363 of this title, or that the debtor may exempt under section 522 of this title, shall deliver to the trustee, and account for, such property or the value of such property, unless such property is of inconsequential value or benefit to the estate.

(b) Except as provided in subsection (c) or (d) of this section, an entity that owes a debt that is property of the estate and that is matured, payable on demand, or payable on order, shall pay such debt to, or on the order of, the trustee, except to the extent that such debt may be offset under section 553 of this title against a claim against the debtor.

(c) Except as provided in section 362(a)(7) of this title, an entity that has neither actual notice nor actual knowledge of the commencement of the case concerning the debtor may transfer property of the estate, or pay a debt owing to the debtor, in good faith and other than in the manner specified in subsection (d) of this section, to an entity other than the trustee, with the same effect as to the entity making such transfer or payment as if the case under this title concerning the debtor had not been commenced.

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11 U.S.C. §553 (1988)

(a) Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case, except to the extent that–

(1) the claim of such creditor against the debtor is disallowed other than under section 502(b)(3) of this title;

(2) such claim was transferred, by an entity other than the debtor, to such creditor–

(A) after the commencement of the case; or

(B) (i) after 90 days before the date of the filing of the petition; and

(ii) while the debtor was insolvent; or

(3) the debt owed to the debtor by such creditor was incurred by such creditor–

(A) after 90 days before the date of the filing of the petition;

(B) while the debtor was insolvent; and

(C) for the purpose of obtaining a right of setoff against the debtor.

(b)(1) Except with respect to a setoff of a kind described in sections 362(b)(6), 362(b)(7), 362(b)(14), 364(h)(2) or 365(i)(2), of this title, if a creditor offsets a mutual debt owing to the debtor against a claim against the debtor on or within 90 days before the date of the filing of the petition, then the trustee may recover from such creditor the amount so offset to the extent that any

insufficiency on the date of such setoff is less than the insufficiency on the later of–

(A) 90 days before the date of the filing of the petition; and

(B) the first date during the 90 days immediately preceding the date of the filing of the petition on which there is an insufficiency.

(2) In this subsection, "insufficiency" means amount, if any, by which a claim against the debtor exceeds a mutual debt owing to the debtor by the holder of such claim.

(c) For the purposes of this section, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition.

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